

of rancour, possibly for reasons given by Driedger, ie, it merely indicates the obligation without expressly imposing it, or possibly for the reason given by Leech, ie, it is more subjective than 'shall.'

In dealing with Driedger's reservation, it is appropriate to remember that it is the *law* that is speaking. The natural implication of 'is required to' or 'must' is that it is a requirement of the law imposing an obligation to the extent necessary to enforce the statement of law. Legal writers have the option of using a suitable alternative.

'Shall' should be abandoned as the copula to indicate modality in law. The colloquial future meaning of 'shall' has probably displaced the Wallis' Rules after 340 years. The law requires certainty and 'shall' does not guarantee certainty.

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Hong Kong Corporate Rescue Proposals: Making Secured Creditors More Secure

A glaring weakness in Hong Kong insolvency law has been the lack of an acceptable corporate rescue procedure. Under existing law it is difficult to reorganise or restructure a company in financial difficulty. Therefore, creditors holding fixed and/or floating charges often resort to receivership and, ultimately, unsecured creditors have little option but to petition for the liquidation of the company. From the perspectives of many of the participants, the result often is wasteful and unsatisfactory. Creditors receive less than they would if the company could be successfully restructured; employees are fired and jobs are permanently lost; and the company directors can be forced into bankruptcy if unable to satisfy their personal guarantees of corporate debt.

These problems are all the more significant in the light of Hong Kong's increasing number of corporate failures. From a low of 151 winding-up orders in 1988–99, the number has climbed to a high of 557 in 1996–97.¹ In 1996–97, the most common causes of corporate failure were a decline in business and cash flow problems.² Given the current state of the economy, companies are likely to continue to encounter such problems.

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¹ *Official Receiver's Office Annual Departmental Report 1996–97* (Hong Kong: Printing Department, September 1997), Annex 6. During the interim, there were 187 winding-up orders made in 1989–90; 306 in 1990–1; 355 in 1991–2; 327 in 1992–3; 433 in 1993–4; 429 in 1994–5; and 514 in 1995–6: *ibid.*

² *Ibid.*, Annex 13.

It appears that help is finally on the way. Over the past year, two important developments have addressed the difficulties in rehabilitating companies in Hong Kong. First, in the spring of 1997, Hong Kong bankers organised a self-help group, the 'Hong Kong INSOL Lenders Group,' to 'formulate an industry consensus in the process of debt restructuring and corporate rescues.'³ Second, and more significant, in October 1996 the Law Reform Commission of Hong Kong (LRC) published its *Report on Corporate Rescue and Insolvent Trading*,⁴ which proposes dramatic changes to facilitate the rescue of financially troubled companies in Hong Kong. It is anticipated that a bill will be gazetted in 1998.

The Report on Corporate Rescue is the second in a series of LRC reports to review and recommend improvements to Hong Kong insolvency law. The first report dealt with the law of bankruptcy.⁵ The third, and likely last, report (to be issued by mid-1998), will incorporate recommendations on other aspects of personal and corporate insolvency law that have not been addressed in the first two reports.

The Report on Corporate Rescue follows upon the *Consultation Paper on Corporate Rescue and Insolvent Trading*,⁶ which was issued by the LRC Sub-Committee on Insolvency in June 1995. Thirty substantive submissions were made on the proposals in this consultation paper, some of which led to amendments included in the Report on Corporate Rescue. Overall, the Report 'substantially supports' the recommendations of the Sub-Committee.⁷

This article discusses the proposed changes to Hong Kong law in the Report on Corporate Rescue. The first part sets out the limitations of the current law, and the remainder discusses the recommendations of the Law Reform Commission.

Current law

Under existing law, the decision whether or not to rescue a company resides primarily with the secured creditors that hold fixed and/or floating charges. In general, unlike a fixed charge which 'attaches' to 'ascertained and definite' property (eg, a company's premises or machinery), a floating charge 'hovers' over a changing class of assets.⁸ Furthermore, the company may continue to deal with that class of assets until the floating charge 'crystallises' and thereby becomes fixed upon the assets in the class.

³ Noel Fung, 'Bankers Forge United Stand on Insolvencies,' South China Morning Post (Business Post), 26 May 1997.

⁴ The Law Reform Commission of Hong Kong, *Report on Corporate Rescue and Insolvent Trading* (Hong Kong: Government Printer, October 1996).

⁵ The Law Reform Commission of Hong Kong, *Report on Bankruptcy* (Hong Kong: Government Printer, May 1995).

⁶ The Law Reform Commission of Hong Kong Sub-Committee on Insolvency, *Consultation Paper on Corporate Rescue and Insolvent Trading* (Hong Kong: Government Printer, June 1995).

⁷ *Report on Corporate Rescue* (note 4 above), para 8, p 3.

⁸ *Illingworth v Houldsworth* [1904] AC 355, 358.

Traditionally, upon the occurrence of specified events of default (such as the failure to repay principal or pay interest upon demand or as otherwise agreed), one would expect a holder of a fixed charge, acting pursuant to the terms of a debenture, to appoint a receiver, and the holder of a floating charge over the company's 'undertaking' or 'undertaking and property' to appoint a receiver and manager. However, the current practice is much more complicated. Debentures frequently provide banks with fixed charges over certain specified assets, including existing and future book debts, and a floating charge over the company's 'undertaking'.⁹ The debentures are thus structured to ensure that if the fixed charge over the book debts is ineffective, the floating charge will protect the secured creditor.¹⁰ In addition, the debentures often define 'receiver' to include receivers and/or receivers and managers. Normally, the debentures also specify that the receiver is an agent of the company and empower the receiver to take control of the charged assets, to commence proceedings in the name of the company, to carry on the business of the company, to enter into contracts on behalf of the company, and to sell the company as a going concern.

The chairman of the Sub-Committee on Insolvency has observed that '[b]ecause receivers sometimes "save" companies in financial difficulties they have been called "company doctors" ...'¹¹ However, the likelihood that a receiver will save a company depends on several concerns of the secured creditor, including whether the charged assets adequately protect the creditor, whether the creditor will benefit if the company continues to trade, and whether the existing client relationship should be preserved. For example, a creditor would more likely agree to rescue a company when the creditor is undersecured and would likely recover a higher percentage of its claim if the company continued in business.¹²

Corporate rescue may also be achieved in those situations where the major secured creditors join with other creditors and enter into an agreement for an out-of-court restructuring. The primary problem is that such an arrangement requires the consent of all creditors. In the absence of unanimity, any objecting creditor may commence or continue litigation against the company (perhaps with the aim of executing against the company's assets) or even petition for the

⁹ For a discussion of the issues relating to the differences between fixed and floating charges, as well as to some of the problems that arise in relation to fixed charges over existing and future book debts, see Gavin Lightman and Gabriel Moss, *The Law of Receivers of Companies* (London: Sweet & Maxwell, 1986), pp 21–6.

¹⁰ An important advantage of a charge created as a fixed charge over a charge created as a floating charge is that the charge created as a fixed charge is not affected by ss 79 and 265(3B) of the Companies Ordinance and is paid in priority to preferential payments owed to other creditors. Similarly, charges created as fixed charges are not subject to avoidance by liquidators under s 267 of the Companies Ordinance.

¹¹ Edward L G Tyler, 'Proposals for a New Corporate Rescue Procedure in Hong Kong,' in Wang Guiguo and Wei Zhenying (eds), *Legal Developments in China: Market Economy and Law* (Hong Kong: Sweet & Maxwell, 1996), p 54.

¹² See *ibid*.

company to be wound up. Nevertheless, as noted in the Consultation Paper on Corporate Rescue, there have been some notable out-of court rescues including the restructurings in the 1980s of the Fung Ping Fan group, the CH Tung group, and the Wah Kwong group.¹³

Finally, the creditors could attempt to save a company by entering into a compromise or a scheme of arrangement under s 166 of the Companies Ordinance. Although s 166 may be utilised after a company has been wound up, such occurrences are very rare.¹⁴ Rather, a compromise or arrangement is typically proposed by either a company or its creditors as a means of avoiding liquidation. For a proposal to be binding on creditors or classes of creditors, it must be accepted by a majority in number and three-fourths in value of the creditors or classes of creditors (as the case may be) who are present and voting either in person or by proxy, and then be sanctioned by the court.

There are several weaknesses with the s 166 process. Most importantly, secured creditors retain veto power over the restructuring process because there is no mechanism to compel an unwilling, or unco-operative, secured creditor to agree to a modification of its contract rights.¹⁵ Furthermore, there is no stay that binds the actions of creditors.¹⁶ Thus, secured creditors may act independently in regard to their security at any time during the s 166 process, even if to the detriment of ever achieving a scheme.¹⁷ Similarly, unsecured creditors may continue or commence actions against the company, execute upon the company's assets, or even petition to have the company wound up.¹⁸ Other problems frequently arise during the reorganisation process. Commentators have noted that the matters involving the classification of creditors are very complex and that the process is expensive and time consuming.¹⁹ One factor contributing to higher costs and time delays is that the s 166 procedures do not limit the number of court applications and hearings.²⁰ The overall result is that there are relatively few successful restructurings of substantial companies in Hong Kong under s 166.²¹ The restructuring of the Associated Hotels group in

¹³ *Consultation Paper on Corporate Rescue* (note 6 above), paras 1.6–8, p 8.

¹⁴ Recently, a s 166 scheme of arrangement was approved in the insolvency of the Bank of Credit and Commerce (Hong Kong) Ltd. However, the scheme was not proposed as a means of saving the bank, which was eventually wound up. Rather, the scheme was proposed for reasons of economy and efficiency to pay in full the claims of small depositors who were owed less than \$100,000.

¹⁵ See *Report of the Review Committee on Insolvency Law and Practice in the United Kingdom*, Cmnd 8558 (London: Her Majesty's Stationery Office, June 1982), under the Chairmanship of Sir Kenneth Cork, para 418, p 101 (the *Cork Report*); Stewart Smith, 'Some Problems in Reorganising Insolvent Companies,' in Malcolm Merry (ed), *Law Lectures for Practitioners 1983* (Hong Kong: The Hong Kong Law Journal Ltd, 1983), p 231.

¹⁶ The *Report on Corporate Rescue* lists this as the major deficiency under s 166: note 4 above, para 1.2, p 7.

¹⁷ See Smith (note 15 above), pp 231–2.

¹⁸ See *ibid*, pp 231, 244–5; *Cork Report* (note 15 above), paras 406 and 408, p 98.

¹⁹ Smith (note 15 above), pp 244–7; Tyler (note 11 above), pp 55–6.

²⁰ *Report on Corporate Rescue* (note 4 above), para 1.7, p 9.

²¹ *Ibid*, para 1.2, p 7.

1985 is the only success story under s 166 that is noted in the Consultation Paper on Corporate Rescue.²²

The Law Reform Commission's proposed corporate rescue procedure

Reasons for change

In its Report on Corporate Rescue, the LRC recommends the enactment of legislation to provide for the provisional supervision of companies. Provisional supervision is intended to supplement, rather than replace, s 166 of the Companies Ordinance. Chapter 1 of the Report elucidates five advantages of provisional supervision over s 166. In short:

- (1) It will be easier to calculate the time and costs involved in putting a proposal to creditors under provisional supervision than is possible under the open-ended procedures in s 166.
- (2) A moratorium on creditors' actions will be provided under provisional supervision.
- (3) The costs of court appearances will be decreased under provisional supervision, as the number of court applications and hearings will be limited.
- (4) Provisional supervision will include several innovations:
 - (a) the role of the provisional supervisor will be set out;
 - (b) the provisional supervisor will be provided with the power of management;
 - (c) 'rogue creditors' will be prevented from leveraging their position by threatening proceedings;
 - (d) lenders during provisional supervision will benefit from super priority; and
 - (f) there will be a smooth transition into company voluntary arrangement or winding up, as the case may be; and
- (5) Provisional supervision will provide certainty; creditors will have the opportunity in most cases to vote on a proposal within six months.²³

These are substantial improvements upon s 166. However, noticeably absent from this list (with the exception of the moratorium) are recommendations to reduce the role played by secured creditors. Rather, the LRC has decided to retain and, in some important aspects, even strengthen the dominant position of secured creditors. This result reflects the powerful position of the banking industry in Hong Kong generally, and in the s 166 reorganisation process in particular.

²² Consultation Paper on Corporate Rescue (note 6 above), para 1.5, p 8.

²³ Report on Corporate Rescue (note 4 above), para 1.7, pp 8-9.

In arriving at its proposals, the LRC benefited from the reports of law reform committees elsewhere — notably the Cork Report in the United Kingdom²⁴ and the Harmer Report in Australia.²⁵ The Commission's recommendations also draw upon aspects of the company rescue procedures in many countries, including the United Kingdom,²⁶ Australia,²⁷ Canada,²⁸ and (to a lesser extent) the United States.²⁹ The Commission notes, however, that the proposed Hong Kong provisional supervision procedure, 'while borrowing from other procedures, has its own characteristics and is quite distinct.'³⁰

The LRC's proposals are premised on the notion that:

In our view, it is beyond dispute that it is better for a viable business to survive as a going concern, in whole or in part, than for it to be simply wound up and such assets as remain distributed. It benefits the company's shareholders, as if the company survives, their share holdings might become valuable, whereas if a company is insolvent and wound up they get nothing. It benefits the ordinary creditors of the company if they obtain more from a company reorganisation than from a dividend in a winding up, with the added benefit that they would keep a customer. It has become increasingly clear that secured creditors, usually banks, must look beyond the notion that being secured means that they are not affected by the winding up of a client company. Employment that would otherwise disappear would be preserved, at least to some extent. All of this has implications for Government both in revenue and social terms.³¹

For the most part, these goals are reflected in the Commission's recommendations. However, as will be seen below, certain secured creditors will retain the ability to act independently and bypass the proposed corporate rescue procedure.

Commencement of provisional supervision

The provisional supervision 'procedure aims to facilitate the rescue of those companies that have viable businesses which are worth saving in whole or in part.'³² The procedure will apply to Hong Kong companies (which are formed

²⁴ See note 15 above.

²⁵ The Law Reform Commission of Australia, *General Insolvency Inquiry*, Report No 45 (Canberra: Australian Government Publishing Service, September 1988), Mr Ron Harmer, Commissioner-in-charge.

²⁶ United Kingdom Insolvency Act 1986, Parts I and II (Company Voluntary Arrangements and Administration Orders).

²⁷ Australian Corporate Law Reform Act 1992 (Voluntary Administration and Deeds of Company Arrangement).

²⁸ Canadian Bankruptcy and Insolvency Act 1992, Part III, Div I (General Scheme for Proposals).

²⁹ 11 USC ss 1101–74 (1997) (US Bankruptcy Code, Ch 11 — Reorganisation).

³⁰ *Report on Corporate Rescue* (note 4 above), para 1.28, p 14.

³¹ *Ibid*, para 1.18, p 11.

³² *Ibid*, para 2.3, p 20.

and registered under Part I of the Companies Ordinance) and to oversea companies (which are registered under Part XI of the Companies Ordinance), with the exception of certain regulated industries.³³

Provisional supervision will be available to both solvent and insolvent companies. It is expected that the procedure normally will be initiated by a majority of the directors of the company or by the members of a company by ordinary resolution.³⁴ Where a winding-up petition has been filed but a winding-up order has not yet been made, a provisional liquidator may initiate the procedure (except where the directors have made a declaration under s 228A of the Companies Ordinance).³⁵ Where a liquidator has been appointed, the liquidator's consent will be necessary for a provisional supervision to go forward.³⁶ In addition, a receiver appointed over the whole or substantially the whole of a company's assets will also be permitted to initiate the procedure.³⁷

The provisional supervisor

The party that initiates the procedure will nominate the 'provisional supervisor,' the person who is responsible for preparing the corporate rescue proposal. The provisional supervisor will be chosen from a panel of insolvency practitioners (comprising both solicitors and accountants) in order of rotation.³⁸ In exceptional circumstances, the court may approve the appointment of an individual not on the panel who possesses skills not available on the panel.³⁹ In addition to formulating a draft plan of voluntary arrangement, during the period of provisional supervision the provisional supervisor's other functions will include 'manag[ing] the affairs, business and property of the company with the primary purpose of preserving the assets of the company for the creditors as a whole.'⁴⁰ To assist him in achieving his goals, Chapters 8 and 9 of the Report on Corporate Rescue outline the provisional supervisor's role, powers, duties, rights, and liabilities.

Upon his appointment, the provisional supervisor will take control of the company and the powers of directors will be suspended.⁴¹ Thus, although the

³³ Eg, the banking, insurance, and securities and futures industries: *ibid*, paras 2.12–23, pp 22–5.

³⁴ *Ibid*, para 4.3, p 29.

³⁵ *Ibid*, para 4.7, p 30.

³⁶ *Ibid*, para 4.13, p 32.

³⁷ *Ibid*, para 4.10, p 31.

³⁸ This panel will be similar to the Administrative Panel of Insolvency Practitioners for Court Winding-up, which has been operating since May 1996 for non-summary compulsory liquidations. The panel will be composed of firms that have at least two qualified practitioners with the required amount of insolvency experience: *ibid*, paras 7.4–6, pp 48–9.

³⁹ *Ibid*, para 7.7, p 49.

⁴⁰ *Ibid*, para 8.7(h), p 54. The provisional supervisor will be personally liable on any contract entered into by him in the performance of his functions, but will be entitled to an indemnity out of the company's assets: *ibid*, para 9.13, p 63.

⁴¹ *Ibid*, para 8.17, p 56.

directors will normally initiate the procedure, as a rule they will immediately be displaced by the provisional supervisor. However, the provisional supervisor may choose to delegate certain powers back to the directors, in which case the directors will be answerable to him.⁴² Clearly, provisional supervision will more likely succeed in cases in which the directors co-operate with the provisional supervisor.

Company officers and other specified individuals will be required to provide the provisional supervisor with a statement of affairs.⁴³ This information will assist the provisional supervisor in assessing the company's financial position and in deciding whether to formulate a plan of voluntary arrangement. The provisional supervisor will be required to draft his assessment in the form of a report that will assist creditors in making an informed decision whether or not to support the proposed corporate rescue proposal.

The provisional supervisor's powers include the powers to borrow money, to grant charges over the company's assets, and to disclaim onerous contracts.⁴⁴ There are limitations, however — for example, a provisional supervisor will not be allowed to dispose of assets secured by a charge without receiving the consent of the holder of the charge.⁴⁵ In exercising his powers, the provisional supervisor will be deemed to be the agent of the company.

The provisional supervisor will be required to act in accordance with a strict time schedule. He will be expected to determine within the initial thirty days of provisional supervision whether the purposes of a voluntary arrangement are capable of being achieved⁴⁶ and to put the proposal for a voluntary arrangement to creditors within six months.

The moratorium

The 'cornerstone' of provisional supervision is the moratorium, or stay of proceedings.⁴⁷ Under s 166, a single creditor can bring the rehabilitation process to a standstill by presenting a winding-up petition against the company. Moreover, as noted earlier, a secured creditor may appoint a receiver to realise the assets subject to its charge. Actions such as these, although in the moving creditor's interest, adversely affect the interests of other parties. A moratorium has therefore been incorporated into the proposed provisional supervision procedures to elevate the interests of creditors as a whole above the self-interest of individual creditors. The inclusion of the stay greatly increases the likelihood

⁴² Ibid, para 8.22, p 57; para 1.33, p 15.

⁴³ Ibid, para 10.3, p 66.

⁴⁴ Ibid, para 8.25(g) and (j), p 58.

⁴⁵ Ibid, para 13.17, p 79. It is anticipated that after the provisional supervision provisions are enacted, holders of floating charges will draft their debentures to provide that the commencement of a provisional supervision is an event that crystallises a floating charge into a fixed charge.

⁴⁶ Ibid, para 14.1, p 80.

⁴⁷ Ibid, para 5.2, p 33.

that a plan of voluntary arrangement will be adopted. An added benefit is that the stay creates a 'cooling-off' period during which the provisional supervisor may meet with creditors with the aim of drafting a proposal.

Of course, it would be unfair to creditors for the moratorium to be opened. Thus, the moratorium will last for an initial thirty-day period. If the provisional supervisor is unable to formulate a plan within that period, he may apply to the court for an extension or extensions of the moratorium for up to six months.⁴⁸ The moratorium may only be extended beyond six months with the agreement of creditors.⁴⁹

The moratorium will prevent unsecured creditors from petitioning for the winding up of the company or commencing or continuing proceedings, execution, or attachment against the company or its assets.⁵⁰ A major improvement over s 166 is that the moratorium in provisional supervision also applies to secured creditors. However, the moratorium against secured creditors is not as far-reaching as it first appears. Some secured creditors — those defined in the Report on Corporate Rescue as 'major secured creditors' — are given the right to elect whether or not to participate in a provisional supervision.⁵¹ A major secured creditor is defined as a 'holder of any charge [whether fixed or floating or a combination of the two] over the whole or substantially the whole of a company's assets, whose level of exposure or lending would warrant such an extensive charge.'⁵² If a major secured creditor elects not to participate, then provisional supervision will immediately cease.⁵³ Non-major secured creditors will not have the option of electing whether or not to participate.⁵⁴

Any secured creditor that elects to participate, or which does not have the right to elect to participate, will be bound by the moratorium.⁵⁵ During the continuance of the stay, a secured creditor may not appoint a receiver; if it has already done so, the receiver may not exercise any powers incidental to receivership.⁵⁶ Furthermore, a secured creditor may not enforce its charge over the company's property or repossess goods in the company's possession.⁵⁷

Creditors who are experiencing 'significant financial hardship' as a result of the moratorium may apply to the court to be exempted from the moratorium and thereby from any subsequent voluntary arrangement.⁵⁸ In addition, the

⁴⁸ Ibid, paras 5.12–14, p 35.

⁴⁹ Ibid, para 5.5, p 33.

⁵⁰ Ibid, para 5.18(a) and (e), pp 36–7.

⁵¹ Ibid, para 13.8, pp 76–7.

⁵² Ibid, paras 13.7–8, p 76.

⁵³ Ibid, para 13.9, p 77.

⁵⁴ Ibid, para 13.14, p 79.

⁵⁵ Ibid, para 13.10, p 77 and para 13.14, p 78. Major secured creditors that fail to make an election within three days of receipt of the notice of election will be deemed to have elected to participate: *ibid*, para 13.10, p 77.

⁵⁶ Ibid, para 5.18(c), p 36.

⁵⁷ Ibid, para 5.18(d), p 36.

⁵⁸ Ibid, para 5.36, p 40.

provisional supervisor has the power to exclude any class or classes of creditors from the moratorium.⁵⁹

By giving major secured creditors the right to elect not to participate — and thereby to veto a proposed provisional supervision — the LRC further strengthens the position of the banking interests in Hong Kong. Initially, the Sub-Committee had recommended that only holders of floating charges over the whole or substantially the whole of a company's assets should be given the right to elect not to participate. However, this proposal was challenged by a submission of the Hong Kong Association of Banks, which argued 'that the distinction between fixed and floating charges was artificial and would not in all circumstances reflect the level of a creditor's involvement in the company.'⁶⁰ Ultimately, both the Sub-Committee and the Commission accepted this argument, which is incorporated into the Report on Corporate Rescue.

It is debatable whether it was necessary to extend the right of election to holders of fixed charges. Furthermore, it is unfortunate that a major secured creditor is allowed to elect not to participate without submitting any justification for its decision. The LRC's proposals should be amended to permit a major secured creditor to 'opt out' only when the creditor can demonstrate to the court that opting out would increase the likelihood of collecting a greater portion of its secured debts. Furthermore, secured creditors should not be allowed to opt out in those situations where their security interests would be subject to avoidance by a provisional supervisor or a liquidator. Such requirements would better balance the needs of major secured creditors against the interests of other creditors and the company and its employees.

Treatment of employees

At present, when a company is wound up, employees are entitled to seek payments from the Protection of Wages on Insolvency Fund, for certain unpaid wages, unpaid wages in lieu of notice, and unpaid severance payments.⁶¹ Under the proposed provisional supervision scheme, many employees will retain jobs that would otherwise have been lost if their employer had been wound up. However, in many cases some employees will be laid off in a cost-saving move by the provisional supervisor. The Report on Corporate Rescue proposes that statutory changes be enacted to enable such employees to claim against the Protection of Wages on Insolvency Fund.⁶² Until such an amendment is made,

⁵⁹ Ibid, para 5.37, p 41. The provisional supervisor will have to reach an accommodation with such exempted creditors: *ibid*. The *Report on Corporate Rescue* also proposes to exempt from the moratorium the set-off of certain debts and the settling of 'eligible financial contracts': see *ibid*, paras 5.23–31, pp 38–40.

⁶⁰ Ibid, para 13.1, p 75.

⁶¹ Protection of Wages on Insolvency Ordinance, s 15. The Protection of Wages on Insolvency Fund, in turn, attempts to recoup such payments in the company winding up. See Companies Ordinance, s 265.

⁶² *Report on Corporate Rescue* (note 4 above), para 5.42, p 42.

the Report proposes a change along the lines of s 79 of the Companies Ordinance, which would give a priority in payment to those claims of employees that would be preferential payments under s 265 of the Companies Ordinance. From the assets coming into his hands, the provisional supervisor would make such payments in priority to all other debts, according to their respective priorities under s 265.⁶³

The Report also proposes that prior wages of employees who retain their jobs during the provisional supervision should be treated the same as the wages of workers who have been laid off.⁶⁴ Furthermore, the Report recommends that relevant statutory amendments be made to ensure that in cases where a provisional supervision leads to liquidation, debts incurred within four months of the commencement of the provisional supervision shall be deemed to have arisen within four months of the commencement of the winding up.⁶⁵ Finally, the wages of workers retained during provisional supervision should be payable in 'the normal way'.⁶⁶

The proposed treatment of the pre-provisional supervision debts of employees is consistent with the treatment of employees in receiverships and liquidations. However, it is unclear why wages payable to employees during provisional supervision should merely be paid in the normal way. It would be fairer to employees if these debts were entitled to super priority. If this change were made, employees supplying their labor to a company during provisional supervision would receive treatment similar to that received by banks that lend money to a company during provisional supervision.

Super priority borrowing

The success or failure of a provisional supervision will frequently depend on whether the company is able to borrow sufficient amounts of working capital to keep the company afloat. The LRC explicitly addresses this problem by recommending that loans made to a company during provisional supervision should receive super priority over the debts of all creditors that are subject to the moratorium, with the exception of debts secured by fixed charges.⁶⁷ Super priority lending will most certainly provide crucial funding during provisional supervision. Of course, the awarding of a super priority does pose risks for existing creditors. Therefore, the Report on Corporate Rescue proposes that existing creditors should have the right of first refusal to decide whether to provide super priority lending. Only upon the refusal of existing creditors would the provisional supervisor be able to approach other sources for borrowing.⁶⁸

⁶³ Ibid, paras 5.42–43, p 42.

⁶⁴ Ibid, para 5.44, p 42.

⁶⁵ Ibid, para 5.45, pp 42–3.

⁶⁶ Ibid, para 5.44, p 42.

⁶⁷ Ibid, paras 12.1 and 12.3, p 73.

⁶⁸ Ibid, para 12.2, p 73.

Avoidance powers

The Report on Corporate Rescue fails to include a detailed, coherent discussion on the proper scope of a provisional supervisor's avoidance powers. Rather, scattered sections in the Report address specific avoidance powers. For example, the Report recommends that a provisional supervisor should be empowered to attack certain charges:

Where a company is in provisional supervision, any charge on the undertaking or property of the company created within twelve months of the commencement of the provisional supervision should, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the rate specified in the charge or at the rate of twelve per cent per annum, whichever is less.⁶⁹

This proposal, although based on s 267 of the Companies Ordinance, appears to be broader in scope and to extend to *both* fixed and floating charges. The gazetted bill will have to clarify this matter.

In contrast, the provisions in the Companies Ordinance regarding unfair preferences (ss 266–266B)⁷⁰ will not be extended to provisional supervision. (It is understood that this omission was deliberate, given that there were concerns that the inclusion of such provisions would create disincentives for directors contemplating whether or not to commence provisional supervision.) Rather, the Report recommends that if the creditors decide that a provisional supervision should be terminated in favour of liquidation, 'the company should be deemed to have been in a creditors' voluntary winding up from the date of the appointment of the provisional supervisor.'⁷¹ This will enable the liquidator to use s 266 to attack pre-provisional supervision transactions.

Elsewhere in the Report, the LRC recommends that a provisional supervisor should *not* be permitted to make an application for the newly proposed offence of insolvent trading, noting that a provisional liquidator would not have sufficient time to pursue such an application.⁷² Perhaps similar reasoning was also a factor in the Commission's decision to prohibit s 266 recovery actions in a provisional supervision.

It would be best for the restructuring process to allow a provisional supervisor to exercise the full range of avoidance powers available to a liquidator in a winding up. The Commission's failure to provide for the

⁶⁹ Ibid, para 13.19, p 79.

⁷⁰ New s 266B of the Companies Ordinance was enacted in December 1996 pursuant to s 76 of the Bankruptcy (Amendment) Ordinance 1996. This amending ordinance comes into operation on 1 April 1998.

⁷¹ See *Report on Corporate Rescue* (note 4 above), para 14.11, p 82.

⁷² Ibid, para 19.11, p 103.

application of these powers is an unnecessary concession to corporate management and powerful creditors. Arguments based on efficiency and the need to create incentives for corporate directors must be balanced against the need to allow the provisional supervisor to protect the interests of creditors generally. Although it is true that a provisional supervisor might not have sufficient time to oversee an avoidance action through to completion, the fact that a provisional supervisor could commence such an action would in many cases lead the affected creditor to be more receptive to a proposed plan of voluntary arrangement that it might otherwise prefer to oppose. Creditors and insiders should not be able to use the provisional supervision process to shield transactions that would be subject to avoidance in liquidation.

The plan of voluntary arrangement

The provisional supervisor is responsible for drafting the proposal for voluntary arrangement. The draft arrangement plan should be in the form 'of a concise statement of the proposed voluntary arrangement which should be capable of being understood by an average creditor in a reasonably short time.'⁷³ Beyond that, the requirements for the plan contents have deliberately been left open-ended 'entirely at the discretion of the provisional supervisor.'⁷⁴ In the draft plan, the provisional supervisor might propose a variety of restructuring solutions for the company, including:

- (a) an extension of time for payment of debts,
- (b) a composition in satisfaction of its debts,
- (c) the compromise of any claims against the company,
- (d) the variation or the reordering of the rating for payment of its debts or any class of its debts,
- (e) the conversion of its debts in whole or in part into shares or other securities to be issued by the company, or ...
- (f) any other scheme or arrangement in relation to the affairs of the company.⁷⁵

The provisional supervisor must call a meeting of creditors to consider the proposed plan. Before the meeting, each creditor will receive a summary of the main features of the plan of arrangement and have the opportunity to inspect the draft plan, the provisional supervisor's report, a projected cash flow statement, and a statement by the provisional supervisor relating to the voluntary arrangement.⁷⁶ At the meeting, creditors should be able to decide to:

⁷³ Ibid, para 14.4, pp 80–1.

⁷⁴ Ibid, para 14.3, p 80.

⁷⁵ Ibid, para 3.6, pp 26–7.

⁷⁶ Ibid, paras 15.8–9, p 84.

- (a) approve the draft arrangement plan with or without modifications, or
- (b) adjourn the meeting to allow the provisional supervisor to submit a modified arrangement plan, or
- (c) reject the plan and resolve that the company should be wound up and a liquidator appointed.⁷⁷

The Report is unclear, however, as to what happens if the creditors are unable to agree upon any of these options.

The proposal will be put to a vote by a single class of creditors, and for any resolution to pass it will be necessary to gain the assent of a majority in number and in excess of two-thirds in value of all creditors voting on the resolution either in person or by proxy.⁷⁸ Where a voluntary arrangement plan is approved by creditors, the provisional supervision will cease and the terms of the voluntary arrangement will take effect.⁷⁹ There is no need to seek the sanction of the court. The voluntary arrangement will be binding on the company and its members and all creditors who were entitled to vote on the plan. Thus, unsecured creditors bound by the arrangement will not be permitted to commence any proceedings against, or petition for the winding up of, the company. And secured creditors bound by the arrangement will not be allowed to take any steps to enforce their security or appoint a receiver.⁸⁰ These restrictions shall continue unless and until the company breaches any of its obligations under the arrangement.⁸¹

The Report on Corporate Rescue notes that the proposed voting arrangements should protect all creditors — secured creditors because they are likely to account for most of the debt, and unsecured creditors because they are likely to outnumber the secured creditors.⁸² However, the Report elsewhere acknowledges 'that once unsecured creditors saw that major secured creditors had put their weight behind a provisional supervision they would be encouraged to vote for participation in a voluntary arrangement.'⁸³ This second statement more accurately reflects the likely result — the secured creditors will control the process.

Although it is true that a single class is administratively simpler and less likely to delay the rehabilitative process, it does have the potential to cause serious conflicts between different groups of creditors. For example, assume that a provisional supervisor proposes a plan that adequately protects the interests of secured creditors *and* provides that unsecured creditors get repaid

⁷⁷ Ibid, para 15.10, p 85.

⁷⁸ Ibid, para 16.37, p 94.

⁷⁹ Ibid, para 16.42, p 95.

⁸⁰ Ibid, para 17.1, p 97.

⁸¹ Ibid, para 17.2, p 97.

⁸² Ibid, para 16.9, p 88.

⁸³ Ibid, para 16.13, p 89.

in full. Also assume that all of the unsecured creditors support the proposed plan. However, the major secured creditor (whose vote is necessary to gain approval) chooses to vote against the plan of voluntary arrangement after deciding that it would rather appoint a receiver and manager and protect its position independently of the plan. Under the proposed procedures, the secured creditor would be entitled to follow this course of action to the detriment of unsecured creditors.

Secured creditors are further protected in that a plan may not modify or otherwise affect their rights unless they consent to the proposed modification or impairment. (There is no procedure for approving such modifications over the objection of the secured creditor, even if the secured creditor unjustly withholds its consent.) In contrast, the rights of unsecured creditors may be modified without securing their individual consent.

There are ways to address these problems. First of all, it would be helpful to organise unsecured and secured creditors into separate classes, as the Sub-Committee on Insolvency initially believed.⁸⁴ Any class whose rights are not modified or otherwise affected should be deemed to accept the plan. As for those classes whose rights are modified or otherwise affected, there should be a mechanism for ensuring that any objecting creditors in a class will receive not less than they would receive if the company were to be wound up.⁸⁵ Moreover, there should be an additional mechanism to enable a plan to be approved over the objection of a class of creditors. In the United States, such a mechanism is called the 'cramdown' provision and requires that a plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.⁸⁶ As can be seen from these proposals, court involvement and/or ratification will be necessary to ensure that objecting creditors are being treated fairly.

These suggestions might serve as a starting point for amending the LRC's proposals relating to voting and plan approval procedures. They are intended to prevent major secured creditors from unfairly scuttling proposed plans and to protect further the interests of unsecured creditors.

Conclusion

The LRC's corporate rescue proposals are a major improvement over existing law and, if enacted, will fill a serious void in the existing corporate insolvency framework. However, the Commission's emphasis on implementing an efficient and simplified procedure has unfortunately further strengthened the

⁸⁴ Ibid, para 16.3, p 87.

⁸⁵ In the United States, this is called the 'best interest of creditors' test. See 11 USC s 1129(a)(7).

⁸⁶ See *ibid*, s 1129(b).

already dominant position of secured creditors. Additional changes are needed to improve the lot of unsecured creditors — restrictions should be put on the ability of major secured creditors to opt out of provisional supervision, the provisional supervisor should be authorised to exercise a broad array of avoidance powers, creditors should be divided into classes for the purpose of voting on a draft plan, and mechanisms should be enacted to ensure that objecting creditors within a class are treated fairly and to prevent classes of creditors from unfairly objecting to a plan. In addition, the position of employees should be further improved by granting them a super priority for wages incurred during provisional supervision. A consequence of such modifications to the LRC's proposals is that the corporate rescue process in some cases might well extend beyond six months. But the added benefit would be to achieve a better balance among the competing interests involved in provisional supervision.

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